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INTERNATIONAL COUNTERTRADE

Draft chapters of legal guide on drawing up contracts in international countertrade transactions**

Report of the Secretary-General

Addendum

XI. LIQUIDATED DAMAGES AND PENALTY CLAUSES

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*Reissued for technical reasons.

**The text contained herein is a first draft prepared by the Secretariat for consideration by the Working Group on International Payments as part of the preparatory work on the draft legal guide on drawing up contracts in international countertrade transactions and should not be regarded as stating the views of the Working Group.

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A. General remarks

1. Liquidated damages clauses and penalty clauses provide that a failure by a party to perform a specified obligation entitles the aggrieved party to receive from the party failing to perform a sum of money agreed upon at the time the parties establish their contractual relationship. The agreed sum may be intended to stimulate performance of the obligation, or to compensate for losses caused by the failure to perform, or both. 1/

2. This chapter focuses on liquidated damages and penalty clauses included in countertrade agreements to cover a failure to fulfil the countertrade commitment. Such a failure may take the form of non-fulfilment or delayed fulfilment of the countertrade commitment. This chapter does not address directly the use of liquidated damages or penalty clauses to support performance of supply contracts that form part of a countertrade transaction. Liquidated damages and penalty clauses are frequently used in sales contracts and other types of supply contracts, and the presence of such clauses in supply contracts that form part of a countertrade transaction does not raise issues specific to countertrade. Nevertheless, the discussion in this chapter of the general characteristics of liquidated damages and penalty clauses is relevant to the use of such clauses in supply contracts.

3. Since liquidated damages or penalty clauses in countertrade agreements stipulate that the agreed sum is payable in case of a failure to fulfil the countertrade commitment, the obligation to pay the agreed sum is determined with reference to the provisions in the countertrade agreement stipulating the actions that must be taken in order to fulfil the countertrade commitment. For example, if the countertrade agreement provides that the countertrade commitment is to be deemed fulfilled upon the conclusion of a supply contract, failure to conclude the supply contract will result in liability under the liquidated damages or penalty clause in the countertrade agreement. If the countertrade commitment is to be fulfilled upon payment for the supply contract, failure to pay for the supply contract will result in liability under the liquidated damages or penalty clause in the countertrade agreement. (Concerning clauses in the countertrade agreement stipulating actions that must be taken in order to fulfil the countertrade commitment, see chapter VII, "Fulfilment of countertrade commitment", paragraphs 10 and 11.)

4. The purchaser's commitment to purchase goods may be covered by a liquidated damages or penalty clause in the countertrade agreement, as may be the supplier's commitment to make goods available. In many countertrade transactions it is only the party who has exported and is committed to counter-import whose commitment is covered by such a clause. That is because that party may be primarily interested in exporting its own goods and may not have the same degree of interest in purchasing goods in return. However, when the party committed to purchase has a particular interest in obtaining the goods, it may be agreed that the party committed to supply the goods would pay an agreed sum in the event that the party committed to supply fails to conclude a supply contract. When both the party committed to purchase and the party committed to supply have a strong interest in the future conclusion of a supply contract, it may be agreed that the commitments of both parties are to be subject to a liquidated damages or penalty clause.

5. Agreement on a sum to be paid upon a failure to fulfil the countertrade commitment has certain advantages. Firstly, the sum constitutes

agreed compensation for such a failure, thereby allowing the parties to avoid the difficulties and expenses that might be involved in proving the extent of resulting losses. Those expenses might be considerable, especially if the aggrieved party had to establish the losses in judicial or arbitral proceedings. Furthermore, the amount of damages that might be awarded in judicial or arbitral proceedings may be uncertain (see chapter XIII. "Failure to fulfil countertrade transaction", paragraphs 12 and 13). An agreed sum is certain, and this certainty may be of benefit to both parties in assessing the risks to which they are subject under the countertrade agreement. Secondly, the agreed sum may serve as the limit to the liability for a failure to fulfil the countertrade commitment. The party whose commitment is covered by the clause is assisted by knowing in advance the maximum liability likely to be incurred in the event of its failure to fulfil the countertrade commitment (see, however, the discussion in paragraph 11, below, as to the possibility of a claim for damages in excess of the agreed sum).

6. Many legal systems have rules regulating liquidated damages and penalty clauses, and those rules will often restrict what the parties may achieve through those clauses. Under some legal systems, clauses fixing an agreed sum to stimulate performance are invalid, and the party who fails to perform is liable only for the damages recoverable under the general law. Those legal systems recognize only clauses by which the parties, at the time of contracting, fix an agreed sum payable as compensation for losses caused by a failure to perform. Under other legal systems, however, clauses fixing an agreed sum payable as compensation, or fixing an agreed sum to stimulate performance, or fixing a sum which has both those purposes, are in principle valid. The courts may have the power to reduce the agreed sum in specified circumstances, in particular if the amount is grossly excessive in the circumstances or if there has been part performance. The courts may also have the power to award additional damages when the actual damages exceed the agreed sum. In those legal systems the parties may not be permitted to derogate from the power of the court to reduce the agreed sum or to award additional damages.

7. A committed party may fail to fulfil its countertrade commitment due to a permanent or temporary impediment for which it is not responsible (for a discussion of such impediments, see chapter XIII, "Failure to complete countertrade transaction", paragraphs 14 to 37). The rule in many legal systems is that the agreed sum is not due if the failure to perform the obligation in question is caused by a permanent impediment for which the obligated party is not responsible. Such an approach is followed in the United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980), article 79 (see also Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance, article 5 (see note 1)). If an impediment prevents performance of an obligation only temporarily, according to a rule found in many legal systems, the time period for performance of the obligation is extended. In the case of temporary impediments, payment under the liquidated damages or penalty clause would be due only for the countertrade commitment remaining unfulfilled after the lapse of the extended fulfilment period. The countertrade agreement may maintain the applicability of those rules and may contain provisions defining exempting impediments and providing a rule for determining when an impediment is deemed permanent (see chapter XIII, "Failure to complete countertrade transaction", paragraphs 18 to 35).

8. Liquidated damages or penalty clauses should be distinguished from two other types of clauses, i.e. clauses limiting the amount recoverable as damages, and clauses providing alternative obligations. A clause limiting the amount recoverable as damages fixes a maximum amount payable if liability is proved. A plaintiff must prove the amount of its losses, and, if the amount falls below the maximum, only the amount proved is recoverable. In the case of liquidated damages or penalty clauses, the agreed sum is recoverable without proof of loss. A clause providing an alternative obligation gives the obligated party the option either of performing a specified obligation or paying an agreed sum. By exercising either option, the obligated party discharges the obligation. Under liquidated damages or penalty clauses in countertrade agreements, the parties do not usually intend that the committed party has the option of paying the agreed sum in place of fulfilling the countertrade commitment. If there is any doubt as to whether the committed party would have such an option, it is advisable that the question be settled in the clause.

9. Clauses discussed in this chapter should also be distinguished from provisions in countertrade agreements establishing the obligation to liquidate through cash payments imbalances in the flow of trade in barter contracts or where countervailing claims for payment are to be set off. Such payments to liquidate imbalances serve the function of payment for goods delivered in one direction that were not compensated by deliveries in the other direction. Furthermore, the amounts of such payments are not set in advance as is the case with liquidated damages or penalties. (For a discussion of clauses concerning the settlement of imbalances in barter, see chapter III, "Contracting approach", paragraph 6, and in setoff arrangements, see chapter IX, "Payment", paragraphs 50 to 52.)

10. As discussed in chapter VIII, "Participation of third parties", the countertrade party committed to purchase or to supply goods may have the right to engage a third party to fulfil that commitment. In some of those cases, it is agreed that the party originally committed is to remain liable for fulfilment of the countertrade commitment. When this is the case, the contract by which the third party is engaged may provide that the third party is to pay liquidated damages or a penalty to the party originally committed in the event of a breach of the third party's commitment to purchase or to supply goods. The purpose of payment of the agreed sum would be to indemnify the party originally committed for its liability for non-fulfilment of the countertrade commitment due to reasons imputable to the third party. The indemnification by the third party of the party originally committed could also take the form of a "hold-harmless" clause of the type discussed in chapter VIII, paragraph 33. Any commitment to conclude future supply contracts that is made by the third party directly to the countertrade party with whom those supply contracts are to be concluded may also be covered by a liquidated damages or penalty clause. (For a related discussion of the engagement of third parties, see chapter VIII, "Participation of third parties", paragraphs 5, 15 and 16 (third-party purchasers), and paragraph 44 (third-party suppliers)).

B. Relationship of recovery of agreed sum to recovery of damages

11. Legal systems often regulate the relationship between the recovery of the agreed sum and the recovery of damages. Since one of the objectives of a

liquidated damages or penalty clause is to avoid the difficulties of an inquiry into the extent of recoverable damages (see paragraph 5, above), under some legal systems the party to whom the agreed sum is owed is not permitted, in cases where recoverable damages under the rules relating to damages exceed the agreed sum, to waive the agreed sum and claim damages. Nor is the party owing the agreed sum permitted, in cases where the amount recoverable as damages is less than the agreed sum, to assert that that party should only be liable for damages. Under other legal systems, however, the party to whom the agreed sum is owed is permitted to prove that the losses exceed the agreed sum. In those legal systems the aggrieved party can, in addition to the agreed sum, recover damages to the extent that the loss exceeds the agreed sum, either unconditionally or subject to satisfying certain conditions (for example, that the failure of performance was negligent, or was committed with an intention to cause loss, or that there was an express agreement that damages for the excess are to be recoverable). In view of such disparities among legal systems, and the differing perspectives from which a liquidated damages clause may be interpreted, it is advisable that the parties, to the extent permitted by the applicable law, settle in the clause the question whether the aggrieved party would be entitled to any damages beyond the agreed sum (Uniform Rules, article 7 (see note 1)). (For further discussion of monetary compensation for failure to fulfil the countertrade commitment, see chapter XIII, "Failure to complete countertrade transaction", paragraphs 12 and 13.)

C. Effect of payment

12. An important question for the parties to consider is whether the payment of the agreed sum has the effect of releasing the obligated party from the countertrade commitment. Often the intention of the parties is that payment of the agreed sum terminates the countertrade commitment. However, since sometimes the parties intend that the agreed sum is to be payable for delay in fulfilment of the countertrade commitment and that the obligated party is not to be released from the countertrade commitment upon payment of the agreed sum, it is advisable for the liquidated damages or penalty clause to contain a clear provision on the effect of payment of the agreed sum. Absent such a provision, the effect of payment would be determined by the applicable law. In some legal systems, absent an express provision by the parties on the effect of payment, a determination of the effect of payment may be made on the basis of circumstances that indicate the intent of the parties (e.g., the amount of the agreed sum) (Uniform Rules, article 6 (see note 1)).

13. The parties may wish to provide for payment of an agreed sum for delay when it is particularly important for the countertrade commitment to be fulfilled by a specified date or for portions of the countertrade commitment to be fulfilled according to an agreed time schedule. The supplier may be interested in such a clause, for example, when the timely fulfilment of the countertrade commitment in one direction is essential for its ability to meet its payment obligations under the supply contract in the other direction. The purchaser may be interested in such a clause, for example, when a commitment has been made to resell the goods by a particular date. (Concerning the amount of the agreed sum payable for delay, see paragraphs 18 and 19, below.)

14. The question of the effect of payment of an agreed sum would also arise when payment is due for a failure to fulfil the portion of a

countertrade commitment allocated to a subperiod of the fulfilment period. In such cases it is advisable to make clear whether any payment is due under the liquidated damages or penalty clause for any unfulfilled portion of the countertrade commitment that is not carried over or that remains unfulfilled upon the expiry of the overall fulfilment period, or whether any payment is due for any unfulfilled portion of the countertrade commitment that is carried over from one subperiod to the next.

D. Amount of agreed sum

15. The amount of the liquidated damages or penalty may be expressed as an absolute amount or as a percentage of the value of the outstanding commitment. Calculating the amount on the basis of a percentage of the outstanding commitment has the advantage of automatically reducing the amount as the countertrade commitment is fulfilled. If there is a guarantee to secure payment of the agreed sum (see paragraph 23, below), it is advisable for the terms of the guarantee to provide that any reduction in the amount of the agreed sum is to result in a corresponding reduction in the amount of the guarantee (see chapter XII, "Security for performance", paragraphs 23 and 24).

16. Determining the appropriate amount for the agreed sum presents certain difficulties. In a long-term countertrade transaction, it may be difficult to estimate at the time of the conclusion of the countertrade agreement the losses that may be suffered at the time of a breach of the countertrade commitment, and accordingly it may be difficult to quantify the amount of the agreed sum that would make it either truly compensatory, or adequate to stimulate performance. From the point of view of the beneficiary of the liquidated damages or penalty clause, the agreed sum should not be fixed at such a low level that the beneficiary will suffer serious uncompensated losses upon a failure of the other party to fulfil the countertrade commitment. Furthermore, a sum that is less than what the obligated party would save by failing to fulfil the countertrade commitment would not serve as a stimulus to fulfil properly and on time. Indeed, it may serve as a stimulus not to do so.

17. In setting the amount of the agreed sum, the parties should bear in mind that the amount of the agreed sum is likely to be viewed by a court as an important factor in determining whether the obligation to pay the agreed sum is intended to compensate for damages or to stimulate performance (see paragraph 6, above).

18. If the applicable law so permits, the beneficiary of the liquidated damages or penalty clause may find it useful for the countertrade agreement to fix an agreed sum at an amount that provides both reasonable compensation and a moderate pressure to fulfil the commitment. In determining what sum is reasonable, parties may consider such factors as the price the supplier would obtain in a substitute sale, the price the purchaser would have to pay in a substitute purchase, losses that might result from non-fulfilment of the countertrade commitment, the extent of the risk that the countertrade commitment will remain unfulfilled and the fact that the sum should be substantial enough to induce performance. Excessive sums should be avoided, as they may deter some potential trading partners from entering into a countertrade agreement. Excessive sums may also make it more difficult to

find a third party willing to become involved in the fulfilment of the countertrade commitment subject to a "hold-harmless" clause (see paragraph 10, above, as well as chapter VIII, "Participation of third parties", paragraph 33). An excessive sum may also have no special deterrent effect if it can be predicted that in all likelihood it will be declared invalid or reduced in legal proceedings (see paragraph 6, above). Furthermore, a party committed to purchase goods and requested to accept an agreed sum set at a particularly high level may as a counterbalance seek a lower price for the goods that party is to purchase, or that party may seek a higher sale price for its own goods. Where the applicable law permits an agreed sum to serve only as compensation, parties should attempt to estimate as accurately as possible the losses the purchaser is likely to suffer. Any records relating to the basis of the estimate and the calculations should be preserved as evidence that the sum was not fixed arbitrarily. In addition, the parties may wish to include a statement in the countertrade agreement that the amount set in the clause represents a good faith estimate of the damages that would be suffered as a result of non-fulfilment of the countertrade commitment.

19. When the clause for the payment of liquidated damages or a penalty covers delay, an agreed sum to be paid is often fixed by way of increments, a specified amount being due for a specified time unit of delay. In such cases it is advisable that a limit be placed on the cumulative amount of the increments. The parties may wish to address the possibility that the failure to fulfil the commitment would continue after the limit is reached. One approach would be to provide that the beneficiary of the liquidated damages or penalty clause is not entitled to recover either further increments in the liquidated damages or penalty, or damages for losses suffered as a result of non-fulfilment of the countertrade commitment after the date on which the limit was reached. Under another approach, after the limit is reached, the beneficiary of the liquidated damages or penalty clause is still entitled to claim fulfilment of the commitment. In this case the parties may agree that if the committed party fails to fulfil the countertrade commitment within an agreed period after the cumulative limit has been reached, the beneficiary of the liquidated damages or penalty clause is entitled to claim an additional agreed sum for non-fulfilment of the commitment. Under either approach it is advisable to provide that the beneficiary of the liquidated damages or penalty clause is entitled to terminate the countertrade commitment once the cumulative amount of the payments for delay is reached.

E. Obtaining agreed sum

20. The parties may wish to provide that the aggrieved party loses the right to claim the agreed sum if a claim is not made within a specified period of time following the expiry of the fulfilment period (e.g., thirty days). The purpose of such a provision is to resolve questions of liability for non-fulfilment of the countertrade commitment within a reasonable period of time following the expiry of the fulfilment period. The period of time for making a demand should be sufficient to permit the parties to determine whether fulfilment of the countertrade commitment has taken place. This would be of particular importance where actions fulfilling the countertrade commitment might be taken shortly before the close of the fulfilment period or where supply contracts are to be concluded with persons other than the party to whom the commitment is owed.

21. In the case of a fulfilment period divided into subperiods, it is advisable that the countertrade agreement indicate whether payment of the agreed sum is due following each subperiod in which there has been a failure to fulfil or only at the end of the entire fulfilment period. If payment is due following each subperiod, a period of time following the expiry of each subperiod could be provided during which payment of the agreed sum could be claimed (see the preceding paragraph).

22. Legal proceedings that might be necessary to recover the agreed sum often entail time and expense. The need to institute legal proceedings may be reduced if the countertrade agreement authorizes the beneficiary to deduct the agreed sum from funds of the other party in the hands of the beneficiary or from funds due by the beneficiary to that party. For example, when it is agreed that the proceeds of the export contract are to be held to pay for the counter-export contract, it may be agreed that the counter-exporter may withhold an amount equivalent to the agreed sum if the counter-importer fails to honour its commitment to enter into a contract for the purchase of counter-export goods (see chapter IX, "Payment", paragraphs 9 and 57). Where the beneficiary of the liquidated damages or penalty clause does not retain the proceeds of a shipment in such a manner, the objective of securing payment of the agreed sum may be achieved by authorizing deduction from funds or claims that are unrelated to the countertrade transaction in question. It may be noted, however, that under some legal systems provisions authorizing deductions are regulated by mandatory rules. Furthermore, a deduction might later be invalidated if the agreed sum deducted was later held by a court to be excessive, and was reduced.

23. The beneficiary of the liquidated damages or penalty clause may wish to include a provision in the countertrade agreement requiring the other party to arrange for a financial institution to give a guarantee in respect of the agreed sum. The beneficiary could then claim the agreed sum from the financial institution according to the terms of the guarantee (possible terms of a guarantee securing payment of the agreed sum are discussed in chapter XII, "Security for performance").

F. Termination of countertrade commitment and clauses for payment of agreed sum

24. Parties may wish to provide that, where an agreed sum for delay is payable by way of increments with a limit on the cumulative amount recoverable (see paragraph 19, above), the countertrade commitment may not be terminated until the limit is reached on the ground of the failure to fulfil for which the agreed sum is provided.

25. The parties may also wish to provide that termination after the limit is reached is not to affect any obligations to pay liquidated damages or penalties that became due prior to the termination. This would avoid the ambiguity that may result due to the rule in some legal systems that the termination of a contract affects obligations that became due prior to the termination of the contract. If, however, the countertrade commitment is terminated before the limit is reached (e.g., when the beneficiary of the liquidated damages or penalty clause terminates the countertrade commitment for a failure other than the one for which the agreed sum has been stipulated), the parties may wish to provide that the termination does not

affect the right to recover an agreed sum due on the date of termination, but that no amount becomes due as the payment of an agreed sum after the termination.

Note

1/ Studies on the nature and operation of liquidated damages and penalty clauses in international contracts are contained in Yearbook of the United Nations Commission on International Trade Law, volume X: 1979, part two, I, C, and ibid., volume XII: 1981, part two, I, B, 1. "Uniform Rules on Contract Clauses for an Agreed Sum due upon Failure of Performance" (hereinafter referred to as "Uniform Rules") adopted by the Commission are set forth in the Report of the United Nations Commission on International Trade Law on the work of its sixteenth session, Official Records of the General Assembly, Thirty-eighth Session, Supplement No. 17 (A/38/17), annex I (also reproduced in Yearbook of the United Nations Commission on International Trade Law, volume XIV: 1983, part one, I, A). By its resolution A/RES/38/135 of 19 December 1983, the General Assembly recommended that States should, where appropriate, implement the Uniform Rules in the form of either a model law or a convention. The Uniform Rules may be used to assist in resolving certain issues that arise in regard to liquidated damages and penalty clauses.

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Addendum

XIII. FAILURE TO COMPLETE COUNTERTRADE TRANSACTION**

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* The text contained herein is a first draft prepared by the Secretariat for consideration by the Working Group on International Payments as part of the preparatory work on the draft legal guide on drawing up contracts in international countertrade transactions and should not be regarded as stating the views of the Working Group.

** A different title is used in the present addendum for draft chapter XIII than was used in the proposed structure of the legal guide (A/CN.9/WG.IV/WP.51, paragraph 9) and in some other draft chapters.

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A. General remarks

1. This chapter discusses remedies for non-fulfilment of the countertrade commitment (sections B and C). It also discusses circumstances in which a party would be exonerated from liability for a failure to fulfil the countertrade commitment (section D). A further issue discussed in the present chapter is the effect of a failure to fulfil the countertrade commitment or of the failure to perform a supply contract in one direction on the obligations of the parties to conclude or perform supply contracts in the other direction (section E). Not discussed are remedies for non-performance of a supply contract concluded pursuant to the countertrade agreement, since such remedies are of a type available under contract law generally and therefore do not raise issues specific to countertrade.

2. Failure by a party to fulfil its obligations under the countertrade transaction could have serious repercussions for the other party. The repercussions may be, for example, that a prospective supplier will not earn convertible funds planned to be used for purchase of other goods, that a prospective supplier will be hampered in carrying out its plan to introduce countertrade goods into new markets, or that a prospective purchaser will not receive goods to be resold in order to pay for goods shipped in the other direction.

3. It is advisable that the countertrade agreement stipulate the remedies for a failure to fulfil the countertrade commitment. National legal systems generally do not contain rules specifically tailored to countertrade, and general rules applicable to contractual obligations may not provide satisfactory answers when problems occur in fulfilling the countertrade commitment. The remedies that the parties might wish to address in the countertrade agreement include release from the countertrade commitment and liquidated damages or a penalty (see paragraphs 5 to 13, below). It is also advisable that the countertrade agreement define the circumstances in which a party would be exonerated from liability for a failure to fulfil the countertrade commitment (see paragraphs 14 to 37, below).

4. The remedies for non-fulfilment of the countertrade commitment that the parties have decided to include in a countertrade agreement may not be appropriate in every circumstance. Therefore, while a party has the right to insist upon the remedies set forth in the countertrade agreement, the parties may find it desirable to negotiate in the light of the available remedies before resorting to the procedures available to enforce them (see discussion on negotiation in chapter XV, "Settlement of disputes", paragraphs to).

B. Release from part or all of countertrade commitment

5. There are different circumstances in which a party may be released from its obligations under the countertrade commitment. Such a release can result from a payment of liquidated damages or a penalty stipulated in the countertrade agreement for non-fulfilment of the countertrade commitment (see paragraph 10, below, as well as chapter XI, "Liquidated damages and penalty clauses", paragraph). A release of a party may also result when an action or omission by the other party causes the failure to fulfil the commitment (see paragraph 6, below). A further ground for a release may be the occurrence of circumstances that the applicable law or the countertrade agreement defines as exempting impediments (see paragraphs 14 to 37, below). Yet another situation in which a party may be released is when the supply contract in the other direction is terminated (see paragraph 48, below). A party may be released from all of the unfulfilled countertrade commitment or from only a portion thereof. If the circumstances that give rise to the release affect only a portion of the unfulfilled countertrade commitment, the remaining portion of the countertrade commitment remains in effect.

6. The parties may wish to agree that, if the party committed to supply breaches its obligation to make available a portion or all of the goods in accordance with the terms of the countertrade agreement, the party committed to purchase is released from an equivalent portion or all of the countertrade commitment. Similarly, the parties may wish to agree that, if the party committed to purchase breaches its obligation to purchase a portion or all of the goods made available in accordance with the terms of the countertrade agreement, the party committed to supply is released from an equivalent portion or all of the countertrade commitment. When the parties so agree, they may wish to establish a notice requirement. Such a requirement might specify that the aggrieved party has to deliver a notice to the party in breach specifying the breach and informing the party in breach that the aggrieved party would be released from its obligations under the countertrade commitment to the extent that the breach was not remedied within a period of time specified in the notice or in the countertrade agreement. The period of time should be of a sufficient length to allow the remedying of the breach. The parties may wish to provide that the period of time commences to run from the date of the delivery of the notice. The parties may wish to consider whether it would be desirable to provide that, for the release to take effect, a second written notice would have to be delivered by the party claiming release.

7. Sometimes the countertrade agreement sets subperiods within the fulfilment period in which specified portions of the countertrade commitment must be fulfilled (for a discussion of such subperiods, see chapter VII, "Fulfilment of countertrade commitment", paragraphs 27 to 29). Such schemes often provide that a committed party that fails to fulfil the commitment allocated to a given subperiod may carry over a portion of the unfulfilled commitment to the following subperiod and that the party in breach must pay liquidated damages or a penalty on the unfulfilled portion that is not carried over. In such cases it may be provided that the party in breach is to be given an additional period of time, after the expiry of the subperiod, to remedy the breach (see the preceding paragraph).

8. It should be noted that some legal systems contain special requirements for the termination of a contract as a result of a breach. For

example, it may be required that additional time be granted to remedy the breach, that notice of intent to terminate be given, or that judicial consent be given. Were a release from a countertrade commitment to be interpreted as falling under those rules, such requirements might be applicable.

9. The countertrade agreement may provide that, if a release results from circumstances not attributable to either party (e.g., an exempting impediment), each party is to bear its own expenses and losses.

C. Monetary compensation

10. The countertrade agreement may provide that a breach by a party of the countertrade commitment entitles the aggrieved party to receive from the party in breach an agreed sum as liquidated damages or a penalty (liquidated damages and penalty clauses are discussed in chapter XI). It is desirable that the countertrade agreement specify whether a party paying liquidated damages or a penalty is released from the obligations under the countertrade commitment (for a discussion of the effect of payment of liquidated damages or a penalty, see chapter XI, paragraphs to).

11. Liquidated damages and penalties should be distinguished from the obligation found in legal systems generally to pay damages as compensation for loss suffered due to a breach of a contractual obligation. Liquidated damages or a penalty involve an amount agreed upon at the time the contractual obligation is entered into and are payable by a party who failed to perform the obligation without proof of loss by the aggrieved party (chapter XI, paragraph). By contrast, damages are assessed after the failure to perform a contractual obligation so as to compensate for the losses proved to have been suffered by the aggrieved party.

12. It might be possible for the party who suffered loss as a result of a failure to fulfil a countertrade commitment to claim, on the basis of legal rules generally applicable to a breach of a contractual obligation, damages from the party who failed to fulfil the commitment. The problem of liability for failure to fulfil a countertrade commitment raises the question of pre-contractual liability. The answer to this question is often not clear in legal systems, the approaches to the question differ under various legal systems, and the law of pre-contractual liability is undeveloped in some countries. A further source of uncertainty is the basis on which the extent of the damages would be calculated. If the important terms of the future supply contract (in particular type, quality and price of goods) are not sufficiently defined in the countertrade agreement, there would be an insufficient basis on which to calculate damages resulting from a failure to conclude that contract.

13. It is therefore advisable that the parties not leave the question of damages for non-fulfilment of the countertrade commitment to the applicable law. Instead, it is recommended that the parties include in the countertrade agreement a clause on liquidated damages or a penalty (see chapter XI, "Liquidated damages and penalties").

D. Exempting impediments

14. During the course of the period for fulfilment of the countertrade commitment, events may occur that impede a committed party to conclude an envisaged supply contract. An impediment may be of a legal nature, such as a change of regulations in the purchaser's or the supplier's country prohibiting the import or export of certain types of goods. An impediment may also be of a physical nature, such as a natural disaster preventing the production, transport or taking delivery of countertrade goods. Such impediments may prevent fulfilment of the countertrade commitment permanently or only temporarily. The party who fails to fulfil its countertrade commitment due to an impediment may, subject to the applicable law and to the provisions of the countertrade agreement, be granted additional time to fulfil the commitment or be released altogether from the countertrade commitment, and be exonerated from liability to pay damages. Impediments that give rise to such an exemption are referred to in the Legal Guide as "exempting impediments".

15. Many legal systems contain rules concerning exempting impediments. However, those rules may lead to results that are incompatible with the circumstances and needs of international countertrade transactions or do not allocate the risk of occurrence of exempting impediments as desired by the parties. Therefore, the parties may wish to include in their countertrade agreement an exemption clause defining exempting impediments and specifying the legal consequences of those impediments. It is advisable for the parties to select terminology that is, in the light of the applicable law, consistent with their intentions (see chapter IV, "General remarks on drafting", paragraph 6).

16. In the negotiation of the clause in the countertrade agreement on exempting impediments, it is in the interest of each party to have included in the clause the types of exempting impediments that could affect the ability of that party to take the actions required to fulfil the countertrade commitment. For example, the party committed to purchase would be interested in covering impediments such as import restrictions and physical impediments to the taking of delivery or the use of the goods. The party committed to supply goods would be interested in covering impediments such as restrictions on goods permitted to be exported in countertrade transactions and other export restrictions and certain impediments affecting the ability to produce the goods. It should be noted that, under the generally accepted principle of freedom of contract, the parties have latitude to agree on which of the parties is to bear the risk that a particular type of event impeding performance may occur. Accordingly, they would be free to exclude from the list of exempting impediments events that would be treated as exempting impediments by the applicable law and to include other events that would not be so treated by the applicable law.

17. The treatment in various legal systems of the subject of exemption differs with respect to the conceptual underpinnings of the subject and the terminology used. In relation to exemptions in the context of sales contracts, those differences have been bridged by the United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980), article 79. 1/ The approach adopted in that Convention has been designed to take into account the particular circumstances and needs of international trade. The parties may find that approach to be a useful guide in formulating an exemption clause in a countertrade agreement. The discussion in this

chapter of the legal consequences of exempting impediments and the definition of exempting impediments (sections 1 and 2, below, respectively) is based upon the approach taken in the Convention.

1. Legal consequences of exempting impediments

18. The parties may wish to provide that, when fulfilment of the countertrade commitment is prevented by exempting impediments not exceeding a specified duration (e.g., 6 months), the fulfilment period would be extended for a period of time corresponding to the duration of the impediment. The purpose of such a provision would be to ensure that exempting impediments of a limited duration would not release the parties from the countertrade commitment. The parties may wish to stipulate in the countertrade agreement that, if an exempting impediment invoked by a party lasts longer than a specified duration, the other party may claim release from the countertrade commitment, or it may be agreed that either party may do so. The parties may wish to include in such a stipulation the obligation to engage in negotiations aimed at modifying the countertrade agreement in order to preserve the countertrade commitment.

19. As discussed in chapter XI, "Liquidated damages and penalty clauses", paragraph , in order to eliminate any uncertainty, the parties may wish to provide expressly that a party failing to fulfil the countertrade commitment due to an exempting impediment is exempt from the payment of liquidated damages or penalties, or of any damages that would otherwise be due under the applicable law.

2. Defining exempting impediments

20. The parties may wish to include in the countertrade agreement a definition of exempting impediments. The parties may wish to adopt one of the following approaches: (a) providing only a general definition of exempting impediments; (b) combining a general definition with a list of exempting impediments; (c) providing only an exhaustive list of exempting impediments.

(a) General definition

21. A general definition of exempting impediments would enable the parties to ensure that all events having the characteristics set forth in the definition would be considered as exempting impediments. The purpose of a general definition is also to exclude events that do not meet those characteristics. This approach would avoid the need to compile a list of exempting impediments, and would avoid the risk of omitting from the list events that the parties would have considered as exempting impediments. On the other hand, it could be difficult in some cases to determine whether or not a particular event was covered by the general definition.

22. The parties may wish to include in the definition the stipulation that fulfilment of the countertrade commitment must be prevented by a physical or legal impediment (see paragraph 14, above), and not, for instance, only made inconvenient or more expensive. It should be noted, however, that a change in circumstances may occur that makes fulfilment of the countertrade commitment, while still physically possible, excessively costly, beyond what a party could be expected to have foreseen and to have to bear. Such an extreme change in circumstances may be regarded under the applicable law as an exempting

impediment. In addition, the parties may wish to provide that the impediment must be beyond the control of the party failing to fulfil a countertrade commitment and that that party could not reasonably be expected to have taken the impediment into account at the time the countertrade agreement was entered into or to have avoided or overcome the impediment or its consequences.

23. Contractual clauses on exempting impediments sometimes merely list a number of exempting impediments and indicate that other similar events would also be considered as exempting impediments. In such a clause, the listed events serve as an indication whether an event not included in the list should be regarded as an exempting impediment. Nevertheless, inclusion of a general definition in the clause is likely to reduce uncertainty whether an event not included in the list should be regarded as an exempting impediment.

(b) General definition with list of exempting impediments

24. A general definition of exempting impediments might be followed by either an illustrative or exhaustive list of events that are to be regarded as exempting impediments. This approach would combine the flexibility afforded by a general definition with the certainty arising from the specification of exempting impediments.

(i) General definition with illustrative list

25. Examples of exempting impediments to be included in an illustrative list may be chosen so as to clarify the scope of the general definition. Such an approach could give guidance as to the intended scope of the general definition and ensure that the events set forth in the list would be treated as exempting impediments if they meet the criteria set forth in the general definition.

(ii) General definition with exhaustive list

26. A general definition of exempting impediments might be followed by an exhaustive list of events that are to be regarded as exempting impediments if they meet the criteria contained in the general definition. An exhaustive list may be inadvisable unless the parties are certain that they can foresee and list all events which they would wish to be regarded as exempting impediments.

(iii) General definition with list of exempting impediments whether or not they come within definition

27. A general definition of exempting impediments might be followed by a list of events that are to be regarded as exempting impediments whether or not they come within the general definition. This approach may be useful where parties choose a narrow general definition of exempting impediments, but wish certain events that do not fall within the scope of that definition to be regarded as exempting impediments. Since those events would constitute exempting impediments independently of the general definition, the remarks in paragraph 28, below, concerning safeguards that may be adopted when providing a list of exempting impediments without a general definition, are also applicable here.

(c) Exhaustive list of exempting impediments without general definition

28. It is possible for an exemption clause simply to provide an exhaustive list of events that are to be considered exempting impediments, without a general definition. This approach has the disadvantage of not providing general criteria in a definition that the listed events must meet in order to be regarded as exempting impediments. Since such general criteria are not provided, it is advisable for the parties to describe the exempting impediments on the list as precisely as possible. The advantage of such precision is certainty as to the allocation of risk between the parties.

(d) Possible exempting impediments

29. If the parties set forth in the exemption clause a list of events that are to be considered exempting impediments, with or without a general definition, they may wish to consider whether it is desirable to include events such as fire, explosion, and trade embargo. Furthermore, the parties may wish to narrow the scope of the events listed below.

30. Natural disasters. Natural disasters such as storms, cyclones, floods or sandstorms may be normal conditions at a particular time of the year at the relevant location. In such cases, the countertrade agreement contract might preclude a party from invoking them as exempting impediments if they were foreseeable and if effective counter-measures could have been taken (see paragraph 23, above).

31. War (whether declared or not), other military activity or civil unrest. It may be difficult to determine when a war, other military activity or civil unrest can be considered as preventing performance of an obligation. For instance, hostilities may be taking place in the country of a party, but, if commercial activities by that party continue, the hostilities may not actually prevent a party from fulfilling the countertrade commitment. If the countertrade agreement does not contain a general definition of exempting impediments, it may be desirable to specify clearly when a war, other military activity or civil unrest is considered to prevent fulfilment of a countertrade commitment.

32. Strikes, boycotts, go-slows and occupation of factories or premises by workers. The parties may wish to consider whether and the extent to which these events are to be considered as exempting impediments. On the one hand, such events could in a real sense prevent a party from fulfilling its commitment. On the other hand, the parties might consider that it would not be advisable for a party to be exempted from the consequences of a failure to fulfil a commitment when the failure resulted from the conduct of its own employees. In addition, it may be difficult to determine whether or not strikes by employees and other labour disputes are avoidable by a party, and what measures the party might reasonably be expected to take to avoid or to end the strike or dispute (e.g., meeting the strikers' demands). In that connection, the parties may wish to provide that only strikes that do not arise from labour relations between the party and its employees (e.g., sympathy strikes) are to be regarded as exempting impediments.

33. Shortages of raw materials needed in production. The parties may wish to consider whether this is to be considered as an exempting impediment. They

might, for example, consider that it is the obligation of a party to procure raw materials in time and, therefore, preclude a claim for an exemption if the raw materials had not been procured. In some cases, the party may fail to have the materials available on time due to a delay by its supplier. For those cases, however, it would be advisable for the party to ensure that the contract with its supplier of the materials provides for damages for failure to supply the materials.

(e) Exclusion of impediments

34. Whichever approach to defining exempting impediments is adopted, the parties may wish further to clarify the scope of an exemption clause by expressly excluding some events. For example, the parties may wish to exclude from exempting impediments events that occur after a breach of the countertrade commitment by a party and that, but for the breach, would not have prevented fulfilment of the commitment by that party.

35. The parties may wish to consider whether certain acts of a State or of State organs are to be regarded as exempting impediments. A party may be required to secure a licence or other official approval for the conclusion of a supply contract. The countertrade agreement might provide that if the licence or approval is refused by a State organ, or if it is granted but later withdrawn, the party that was required to obtain the licence or approval cannot rely on the refusal or withdrawal as an exempting impediment. The parties might consider that it is equitable for the consequences of the absence of the licence or approval to be borne by the party that had the duty to obtain it, since that party undertook the countertrade commitment knowing of the necessity to obtain the licence or approval and the possibility of its being refused. Moreover, it might be difficult for the other party to determine whether the measures taken to obtain the licence or approval were reasonable (see paragraph 23, above).

3. Notification of impediments

36. It is desirable for the countertrade agreement to obligate a party invoking an exempting impediment to give written notice of the impediment to the other party without undue delay after the party invoking the impediment learned or could reasonably have been expected to learn of the occurrence of the impediment. This notification could facilitate the taking of measures by the other party to mitigate any loss. It may be required that the notice specify details of the impediment, together with evidence that the fulfilment of a countertrade commitment by the party is prevented or is likely to be prevented, and, if possible, the anticipated duration of the impediment. The party invoking the exempting impediment might also be required to continue to keep the other party informed of all circumstances that may be relevant for an ongoing appraisal of the impediment and its effects, and to notify the other party of the cessation of the impediment. It may be provided that a party who fails to notify the other party in time of the exempting impediment loses the right to invoke the exempting impediment. Alternatively, it may be provided that a party who fails to give the required notification in time remains entitled to invoke the clause, but is liable to compensate the other party for losses resulting from the failure. The countertrade agreement might also provide that an exempting impediment, or certain types of exempting impediments, must be verified, for example, by a public authority, notary public, a consulate or chamber of commerce in the country where the impediment occurred.

37. Further, the parties may wish to provide that, upon notification of an exempting impediment, they are to meet and consider what measures to take in order to prevent or limit the effects of the impediment, and to prevent or mitigate any loss that may be caused by it. These measures might include re-negotiation of the countertrade agreement (see paragraph 18, above).

E. Effect on countertrade transaction of failure to conclude or perform supply contract

38. A feature of a countertrade transaction is the link between the supplies of goods in the two directions in that the conclusion of the contract for the supply of goods in one direction is conditioned upon the conclusion of the contract for the supply of goods in the other direction (see chapter II, "Scope and terminology of legal guide", paragraph 1). In view of this link, a question may arise whether a failure to conclude a supply contract or a failure to perform an existing supply contract in one direction should have an effect on the obligation to conclude a supply contract or to perform an existing supply contract in the other direction. For example, if in a counter-purchase transaction the export contract is terminated, the question may arise whether the exporter is entitled to be released from its obligations to purchase goods pursuant to the countertrade commitment. Similarly, if in a counter-purchase transaction the exporter fails to take the action necessary to fulfil the countertrade commitment, the question may arise whether the counter-exporter is entitled to suspend payment under the export contract or to terminate the export contract.

39. Many national legal systems contain general rules of contract law that provide an answer regarding interdependence of obligations incorporated in one contract. The general principle usually expressed in those rules is that non-performance by one party of its contractual obligations under a contract authorizes the other party not to perform its obligations under that contract, and that in some circumstances the other party is authorized to terminate the contract. Usually non-performance of one's own contract obligations and termination of the contract is not authorized when the failure of the other party is not sufficiently serious. National legal systems normally do not provide a specific answer to the question of interdependence of obligations involved in various types of countertrade transactions and also do not clarify to what extent the above-mentioned general principles of contract law can be applied in a countertrade transaction.

40. It is often suggested that the particular contract structure of the countertrade transaction is an important element in determining the interdependence of obligations in countertrade transactions. If the obligations in a countertrade transaction are merged into a single contract, it is generally considered that the mutual obligations are likely to be considered as interdependent (the single-contract approach is discussed in chapter III, "Contracting approach", paragraphs 2 to 9). If, however, separate contracts are used for the shipments in the two directions, it has been suggested that in many legal systems the two sets of obligations would likely be regarded as independent, except to the extent specific contract provisions establish interdependence (the separate-contracts approach is discussed in chapter III, "Contracting approach", paragraphs 10 to 21) [note to the Working Group: paragraphs 9, and 16 to 18, of chapter III would have to be aligned with the present text]. On the other hand, it has been suggested

that despite the use of separate contracts, the obligations in a countertrade transaction could be regarded as interdependent on the ground that those obligations embodied in separate contracts are commercially interrelated and thus form part of a single transaction.

41. Because there is a dearth of judicial and arbitral decisions on the question of interdependence of obligations in countertrade transactions, generalizations cannot be made. The extent of interdependence will depend on the circumstances and contractual provisions of each case. In order to avoid disagreements as to whether a party is entitled to withhold fulfilment of its obligation as regards the supply of goods in one direction on the ground that the other party has failed to fulfil its obligation as regards the supply of goods in the other direction, the parties might wish to include in the countertrade agreement specific provisions indicating the extent of interdependence of obligations. Provisions determining the extent of interdependence of obligations may be included to address in particular the following problems in the fulfilment of the countertrade transaction: (i) failure to conclude a supply contract as stipulated in the countertrade agreement, (ii) termination of a supply contract, (iii) failure to meet a payment obligation under a supply contract, and (iv) failure to deliver goods under a supply contract.

1. Failure to conclude supply contract

42. In transactions in which the parties first conclude the supply contract in one direction (export contract) and leave the conclusion of the supply contract in the other direction (counter-export contract) to a later time (see chapter III, "Contracting approach", paragraphs 12 to 18), the parties may wish to consider whether the failure of the exporter (counter-importer) to take an action necessary to fulfil the countertrade commitment should entitle the importer to suspend payment for the imported goods, or even to terminate the export contract. Such interdependence may be viewed favourably by an importer whose ability to meet payment obligations under the export contract depends on the proceeds of the counter-export contract to be concluded pursuant to the countertrade agreement.

43. In considering whether to establish such interdependence between the countertrade commitment and the export contract, the parties may wish to take into account the possible amount of the counter-exporter's loss arising from the failure to fulfil the countertrade commitment and the possible amount of the exporter's loss arising from the suspension of payment under the export contract or from the termination of the export contract. It may not be desirable to allow a problem in the fulfilment of the countertrade commitment to disrupt the performance of the export contract. The parties may make such an assessment when the price to be paid under the export contract or the possible loss from the termination of the export contract is considerably higher than the possible loss from the failure by the counter-importer to fulfil the countertrade commitment. Furthermore, interdependence may not be desirable because of the possibility that the parties would disagree as to responsibility for the failure to conclude a supply contract. The possibility of suspension of payment under the export contract until the resolution of such a disagreement might introduce an unacceptable degree of uncertainty in the transaction. Moreover, the risk of non-payment under the export contract because of a problem in the fulfilment of the countertrade commitment may make it difficult for the exporter to find a financial institution to finance the

export or to insure a non-payment risk. A reason for the financial institution's reluctance may be the fact that a possible difficulty the exporter may face in fulfilling the countertrade commitment is a circumstance extraneous to the export contract and difficult for the financial institution to assess. For reasons discussed in paragraphs 39 to 41, above, the parties may wish to express in the countertrade agreement such independence of the export contract from the fulfilment of the countertrade commitment.

44. However, in order to protect the interests of the counter-exporter, it may be appropriate to provide in the countertrade agreement for compensation of the loss expected to be suffered as a result of a failure to conclude the counter-export contract. The obligation to provide such compensation may be established by a liquidated damages or penalty clause in the countertrade agreement (see paragraphs 10 to 13, above, as well as chapter XI, "Liquidated damages and penalty clauses", and chapter XII, "Security for performance"). Furthermore, the countertrade agreement may grant the counter-exporter the right to deduct from payments due under the export contract the amount of liquidated damages or a penalty due for the failure to fulfil the countertrade commitment (see chapter IX, "Payment", paragraphs 9 and 57, and chapter XI, "Liquidated damages and penalty clauses", paragraph).

45. In transactions in which a countertrade agreement is concluded before the conclusion of supply contracts in either direction (see chapter III, "Contracting approach", paragraph 19), the parties may not find it useful to entitle a party to suspend performance of, or to terminate, a concluded supply contract in one direction in response to a failure by the other party to take an action necessary to conclude a supply contract in the other direction. In such transactions, the countertrade agreement often provides for the conclusion of a series of supply contracts in both of the two directions. Making the performance of contracts that have already been concluded in one direction dependent on the conclusion of contracts in the other direction may disrupt rather than stimulate orderly implementation of such a countertrade transaction. Accordingly, for reasons discussed above in paragraphs 39 to 41, the parties may wish to indicate expressly in the countertrade agreement that the obligations under the supply contracts in one direction are independent from the fulfilment of the countertrade commitment in the other direction.

46. In some cases the countertrade agreement may provide that a failure by a party to conclude supply contracts in one direction entitles the other party to suspend conclusion of contracts, or to suspend shipment of goods, in the other direction. Such an approach may be used in particular when it is agreed that during the course of the countertrade transaction the value of the goods supplied in one direction should not exceed the value of the goods supplied in the other direction by more than an agreed amount or percentage. This approach may be agreed upon when the parties stipulate that their mutual payment claims arising from the supply contracts in the two directions are to be set off and that the imbalance in the value of goods shipped in the two directions should not exceed an agreed limit (see chapter IX, "Payment", paragraphs 35 to 52, in particular paragraph 49). In order to monitor the level of trade between the parties and to specify the situations in which a party is entitled to suspend conclusion of contracts or supplies of goods, the parties might agree that their mutual supplies of goods are to be recorded in an "evidence account" (see chapter VII, "Fulfilment of countertrade commitment", paragraphs 38 to 44).

47. When the countertrade agreement provides that the countertrade commitment in one direction should not affect obligations under existing supply contracts in the other direction, the countertrade agreement may nevertheless establish sanctions for the failure to fulfil the countertrade commitment. For example, in transactions in which countervailing claims for payment for the supply of goods in the two directions are to be set off, the countertrade agreement may provide that a party that receives more goods than it ships is to liquidate the imbalance either through cash payments or through the shipment of additional goods (see chapter IX, "Payment", paragraphs 49 to 51). When the goods supplied in the two directions are to be paid for independently, the countertrade agreement may contain a liquidated damages or penalty clause or provide for the issuance of a bank guarantee or stand-by letter of credit covering non-fulfilment of the countertrade commitment (see chapter XI, "Liquidated damages and penalty clauses", and chapter XII, "Security for performance").

2. Termination of supply contract

48. A supply contract may be terminated, for example, as a result of a breach of the contract by one party or as a result of an exempting impediment. For reasons discussed in paragraphs 39 to 41, above, the parties may wish to clarify in the countertrade agreement whether such a termination of a supply contract in one direction is to affect the obligations of the parties to conclude a future supply contract in the other direction or to perform an existing supply contract in the other direction. Various solutions can be considered:

(i) not to allow the termination of a supply contract in one direction to affect the countertrade commitment stipulating the conclusion of a supply contract in the other direction, or any obligations under an existing supply contract in the other direction;

(ii) to provide that termination of a supply contract in one direction is to release the parties from the countertrade commitment stipulating the conclusion of a supply contract in the other direction, but that, if a supply contract in the other direction has already been concluded, that supply contract is not to be affected;

(iii) to provide that termination of the supply contract in one direction is to result in the release from the countertrade commitment to conclude a supply contract in the other direction as well as in the termination of any existing supply contract in the other direction, unless specified actions for performance of the existing supply contract have already been taken (e.g., goods have been prepared for shipment or have been shipped).

49. The solution under (i) may be appropriate in transactions in which the countertrade agreement provides for the conclusion of a series of supply contracts in both directions. In counter-purchase and buy-back transactions, it may also be appropriate to provide that the termination of a given counter-export contract should not affect the export contract. In these cases it may be possible for the parties to conclude a substitute supply contract for a terminated supply contract (see paragraph 54, below). Because of this possibility, as well as the possibility of exercising remedies available under the terminated supply contract, the parties may not wish that the termination

of a given supply contract in one direction should affect the conclusion or performance of contracts in the other direction.

50. As to the possible effects of the termination of the export contract in a counter-purchase, buy-back or indirect offset transaction, the solution under (i) may be preferred by the importer (counter-exporter). An important objective of the importer for engaging in countertrade is often to find an outlet for its goods, and the need to find such an outlet would usually not be diminished by termination of the export contract. This solution may also be favoured by a third-party purchaser engaged by the exporter to fulfil the exporter's countertrade commitment; the third-party purchaser may be interested in the countertrade commitment remaining effective in order to be able to earn the fee agreed upon with the exporter or in order to recoup expenses incurred in anticipation of the purchase and resale of the countertrade goods (see chapter VIII, "Participation of third parties", paragraph 32). The exporter (counter-importer), on the other hand, is likely to favour solution (ii), in particular if the exporter does not expect a profit through the purchase and resale of the countertrade goods. In these types of transactions the exporter usually assumes a countertrade commitment in order to be able to export its own goods and would therefore not wish to remain subject to the countertrade commitment upon termination of the export contract, but at the same time would not wish to terminate existing counter-export contracts. In indirect offset transactions there is an additional reason for adopting the solution under (ii), namely, that the exporter (counter-importer) concludes counter-import contracts with third-party suppliers and it would be undesirable to terminate those contracts due to circumstances that do not concern those third parties.

51. The question may arise whether, despite the release from the countertrade commitment, pursuant to the solution in (ii), of the party originally committed to purchase, a third-party purchaser engaged by the exporter (counter-importer) would continue to be entitled to receive a fee from the exporter (counter-importer) for purchases made from the counter-exporter after the release. As discussed in chapter VIII, "Participation of third parties", paragraph 32, it is advisable that the parties provide an express answer to this question in the countertrade agreement.

52. The solution under (iii) might be adopted when the parties consider that the countertrade transaction cannot proceed if a supply contract in one direction is terminated. This might be the case, for example, when the parties agree to link their payment obligations so that the proceeds of the supply contract in one direction would be used to pay for the supply contract in the other direction (chapter IX, "Payment"), or when, as in a direct offset transaction, the goods supplied by one party are to be incorporated in the goods to be supplied in the other direction. The solution under (iii) would also be indicated in buy-back transactions in which the possibility of fulfilling the countertrade commitment is contingent upon the performance of the export contract.

53. When solution (ii) or (iii) is adopted, the parties may wish to clarify in the countertrade agreement that a party would be released from its obligations under the countertrade commitment or an existing counter-export contract on the basis of the termination of the export contract only if that party was not responsible for the termination of the export contract. The

countertrade agreement may further provide that when one of the parties is responsible for the termination of the export contract (e.g., because of delivery of defective goods, because of a failure to obtain administrative approval for the contract, or because of the failure to obtain the issuance of a letter of credit), the other party has an option either of maintaining in effect the countertrade commitment or the counter-export contract or of being released from its obligations thereunder.

54. Paragraphs 48 to 54, above, addressed the question whether a termination of a supply contract in one direction is to affect the obligations of the parties to conclude or perform a supply contract in the other direction. The parties may also wish to consider whether the termination of a supply contract in a given direction should obligate the parties to conclude a substitute supply contract in that same direction. An obligation to conclude a substitute supply contract may be considered appropriate in particular when the countertrade agreement provides for the conclusion of multiple supply contracts or when the countertrade agreement lists different types of countertrade goods.

3. Failure to pay

55. In many countertrade transactions it is agreed that payment under the supply contract in one direction is to be made independently from payment under the supply contract in the other direction. For example, if under a counter-purchase or buy-back transaction the importer would delay its payments to the exporter, the exporter (counter-importer) would not be entitled to withhold payment under the counter-import contract or to set off its claim under the export contract against its payment obligation under the counter-import contract. Similarly, if the counter-importer would delay payment to the counter-exporter, the counter-exporter (importer) would not be entitled to withhold payment under the export contract or to set off the payment claims in the two directions. It is advisable that such agreement on independence of payment obligations be expressed in the countertrade agreement.

56. It may be agreed, however, that, if a supplier has not been paid for goods delivered in one direction, that supplier is entitled to withhold payment for goods delivered in the other direction up to the amount of the outstanding claim or to set off the two countervailing claims.

57. The advantage of independence of payment obligations is that the risk of non-payment under a supply contract in one direction is not increased by making the payment obligation under that contract dependent on the successful performance of a supply contract in the other direction. With such an approach, financing for a supply contract may be easier to obtain because the financing institution, in assessing the risk of non-payment, would not have to take into account circumstances extraneous to the supply contract to be financed (see also paragraph 43, above).

58. The advantage of making the payment obligations interdependent is that of additional security to a party who does not receive payment for the goods it has supplied. If that party withholds payment or sets off the claims for payment under the supply contracts in the two directions, the result would be similar to a linked payment mechanism discussed in chapter IX, "Payment" (i.e., retention of funds, blocking of funds or setoff of countervailing

claims for payment). The difference is that in the case discussed in this section the withholding of payment or setoff of claims is a fall-back right given to a party who does not receive payment, whereas under the linked payment mechanisms discussed in chapter IX, the linkage of payments is the anticipated method of payment.

59. When it is agreed that a party is entitled to withhold payment or to set off the two countervailing payment obligations, it is sometimes also stipulated that the party who delivered goods first (exporter) is entitled to take possession of the goods that are to be delivered by the other party (importer). Taking possession of the goods would enable the exporter, who is holding the outstanding claim, to obtain value and establish a payment obligation that could be set off against the outstanding claim. Such a stipulation is possible where the countertrade agreement specifies the goods that are to be counter-exported. In order to implement such an approach, it is advisable to identify clearly the goods and their location and to consider taking such additional measures as granting the exporter a security interest in those goods and giving the exporter an express right to claim their possession. A further measure may be for the countertrade parties to agree that the counter-exporter is to deposit the goods with a third person and to provide for the release of those goods to the counter-importer under specified conditions.

4. Failure to deliver goods

60. The parties may wish to clarify in the countertrade agreement the consequences for the countertrade transaction of a failure to deliver, delayed delivery, or delivery of non-conforming goods under a supply contract in one direction. For delivery problems that result in the termination of a supply contract in one direction, the parties may wish to clarify in the countertrade agreement, as discussed in paragraphs 48 to 54, above, whether the termination is to affect the obligations of the parties with respect to the conclusion or performance of supply contracts in the other direction. For delivery problems under a supply contract in one direction that do not result in termination of that supply contract, the parties may wish, for reasons explained in paragraphs 39 to 41, above, to provide expressly in the countertrade agreement that there should be no effect on the obligations of the parties with respect to the conclusion or performance of supply contracts in the other direction. Such an independence of the obligations with respect to the shipments in the two directions may not be appropriate in buy-back transactions in which the counter-export of goods is contingent upon the proper implementation of the export contract.

Note

1/ Official Records of the United Nations Conference on Contracts for the International Sale of Goods (document A/CONF.97/18, annex 1); United Nations, Treaty Series, vol. __, No. __, p. ___; Yearbook of the United Nations Commission on International Trade Law, vol. XI:1980, part three, B.